FOR THE RECORD

Reformers Anonymous

The Economist, September 2nd 1995

The little band of economic reformers in Ukraine used to say that their country was a recovering alcoholic gritting its teeth lest it go back on the bottle. The Slav giant has stayed fairly sober since President Leonid Kuchma took office last year. Yet the temptation to hit the booze again is growing; the bills at unrevamped state factories are piling up and there is a harvest at the country's collective farms to be paid for. Does that bode ill for Ukraine's first serious attempt, backed by $5 billion in international aid, to overhaul its economy?

Not necessarily, claims Victor Pynzenyk, Deputy PM for the Economy. The government, he says, will stick to the tough budget and monetary policies needed to meet the IMF's conditions for the third $350m tranche of a $1.8 billion loan, due for approval by the Fund's board this month.

A lot of good has already been done. Inflation is down to 5% a month, too high for comfort yet on target for 1-2% by the year's end. Real wages have risen from $26 a month in October 1994 to $52.5 in July. the foreign-exchange reserves stand above $2 billion, up from $700 m late last year, and debt obligations to Russia are being met for the first time since independence. All a far cry from the grim outlook just a year ago.

But bad omens returned last month. As the government started shelling out subsidies to state farms and ailing government firms, the budget deficit soared. To finance the spending, the government suddenly decided to print lots of money, not previously mentioned to the IMF. This set off a run on the Ukrainian currency, the coupon which had held steady for six months. On August 16th the currency plunged 15% before the central bank stepped in to stabilise it. The intervention cost the bank about $30m.

It may have been worth it. Just as the rouble's collapse last October woke Russian policy-makers up to the dangers of not stabilising, so, Mr. Pynzenyk says, Ukraine's version was "a very good reminder that there's no choice but to carry out financial stabilisation to the end."

Ukraine lacks Russia's natural resources and trade surpluses to soften the impact of deflation. It is also shorter on reformers in government. Mr. Pynzenyk sometimes looks like a general without an army. At a government reshuffle in July, he was originally kept out of the cabinet. In his absence, parliament rewrote the austerity budget to raise spending and breached the spending limits Ukraine had agreed on with the IMF as conditions for its loan. Mr. Kuchma, a former missile-plant director, pledged state patronage for unhappy industrialists among his old friends. Only the hurried arrival in Kyiv of a big cheese from the IMF, Stanley Fischer, persuaded Mr. Kuchma to say he would stick to his original plans. Mr. Pynzenyk got his job back, though with a somewhat thinner portfolio.

The new PM, Evhen Marchuk, a former KGB director, seems to support the economic policy now back in place. He helped Mr. Kuchma pick the cabinet without any prompting from a parliament still dominated by old Communists. With Marchuk and Kuchma genuinely favouring reform, Ukraine may yet catch up to its East European neighbours.

It has a long way to go, especially with privatisation, industrial restructuring and so on. The economy shrank by 12% during the first six months of this year, after a 23% contraction in 1994. A turnaround will not happen until the industrial dinosaurs - a fifth of the labour forced worked in the military-industrial complex - are taken off state hands or allowed to die.

The industrialists are reluctant killers. One way to do in dinosaurs - or reinvent them as another species - is to privatise them. But Ukraine's attempt to sell off state assets, launched in January with the ambitious aim of selling 8,000 large companies this year, has so far pushed only 95 companies into the private sector. Many factories sit idle, but bankrupting them is still, it seems, politically impossible.

Agriculture, potentially a big export business, is also prehistoric. A quarter of the harvest is still bought in by the state, often at below world-market prices. The distribution system is in the hands of government monopolies. Land privatization, promised by Mr. Kuchma, has gotten nowhere because parliament has refused to approve it. The Deputy PM for Agriculture, Petro Sabluk, reimposed grain quotas and licenses and is demanding another $187m in state handouts.

Though the pressure is mounting on the government to soften its reforms, optimistic economists say that Mr. Kuchma has done enough to lay to rest old worries that Ukraine's future as an independent, unified country might be compromised by economic failure. They point to the steady trickle of foreign and domestic investors seeking their fortune: the daily Lufthansa flight from Frankfurt is usually full; total foreign investment since independence hit $500m last month. Pynzenyk says that $2 billion in Ukrainian capital sits unused in banks, and another $12 billion has fled abroad. If taxes and interest rates continue to fall, that money will, Mr. Pynzenyk says, come out of hiding.

Ukrainian reform was never going to happen overnight. After his political victory over parliament, Mr. Kuchma now has more power to steer his cabinet and big bureaucracy. It all depends on the direction he takes them. "They've still got a lot of problems - an industrial collapse, loss of export markets and large energy subsidies," says a western ambassador in Kyiv. "There will be blips, and failures to meet IMF targets. But it should work - eventually."

Ukraine: A Growing Security Role

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The envisaged enlargement of NATO placed a security dilemma before Ukraine. Its admission to NATO being ruled out for a long time to come by the alliance, by Moscow, and by the realities of Ukrainian domestic politics, Kyiv continued to express the fear of being forced into the situation of a "buffer" between Russia and enlarged NATO. Such a situation could be fraught with instability and generate pressures from Moscow to turn the buffer into an ally and outpost of Russia. To obviate or postpone such a development, Ukrainian policy makers had recently urged a cautious pace to NATO's enlargement and redoubled efforts to reassure Russia that it did not face a security threat from Ukraine. But at the same time Kyiv intensified its participation in NATO's Partnership for Peace program to the point of emerging at the forefront of the newly independent countries' cooperation with NATO.

A special session of the North Atlantic Council approved on September 14 Ukraine's individual program of cooperation with NATO under the PFP program. The Brussels meeting upgraded Ukraine's status in relation to NATO by using the 16+1 formula for consultations, a formula available only to Russia until now. The North Atlantic Council recognized in a communiqué Ukraine's key importance to Europe's stability and security, supported Ukraine's independence and integrity, and welcomed its democratic changes and economic reforms.

Ukraine continues in the meantime to face a security challenge in Crimea from the Russian-controlled Black Sea Fleet. Russian - Ukrainian agreements on the fleet's partition and on the status of its future Russian portion on Ukrainian territory are reported to be close to completion, apparently on terms favorable to Russia. But Kyiv now conditions the resolution of those two issues on a further agreement regarding compensation to Ukraine for the use of land, resources, infrastructure, and territorial waters by the future Russian portion of the fleet.